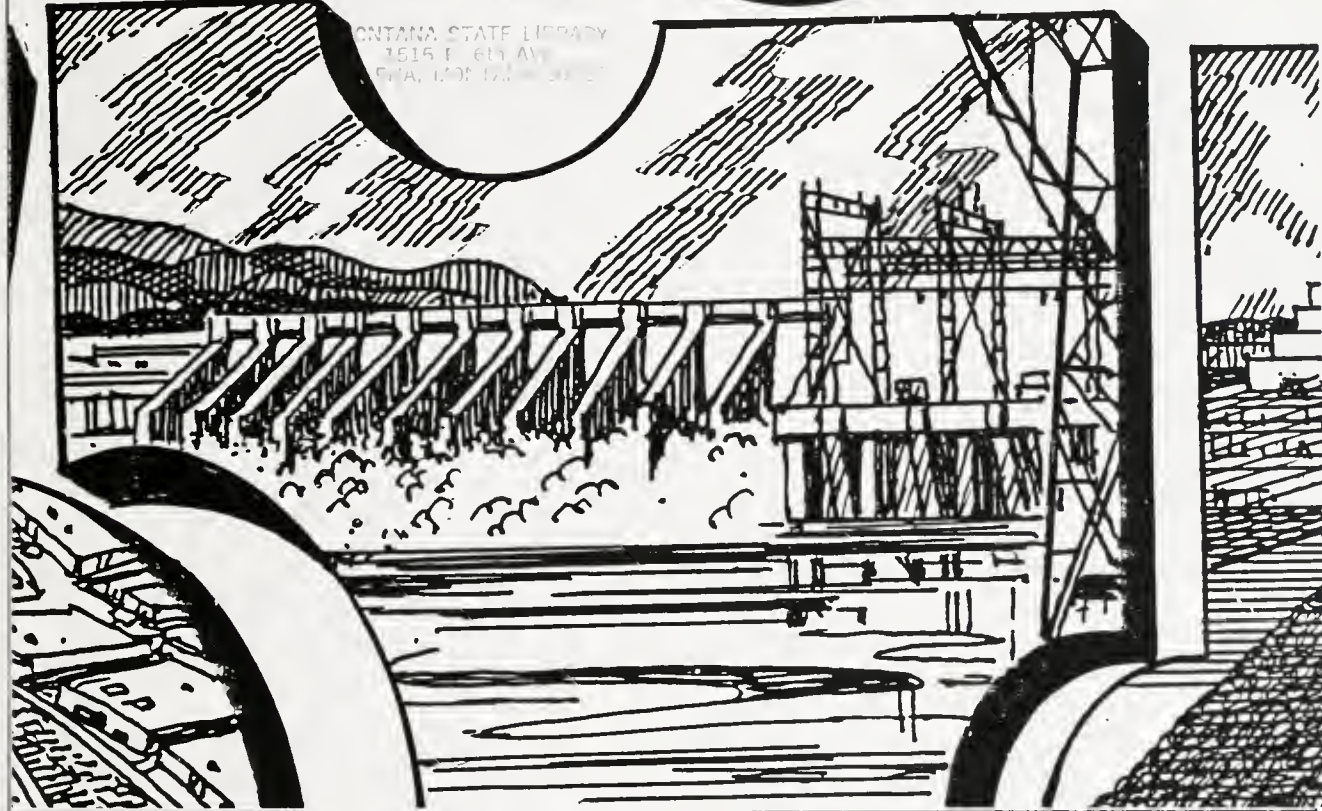
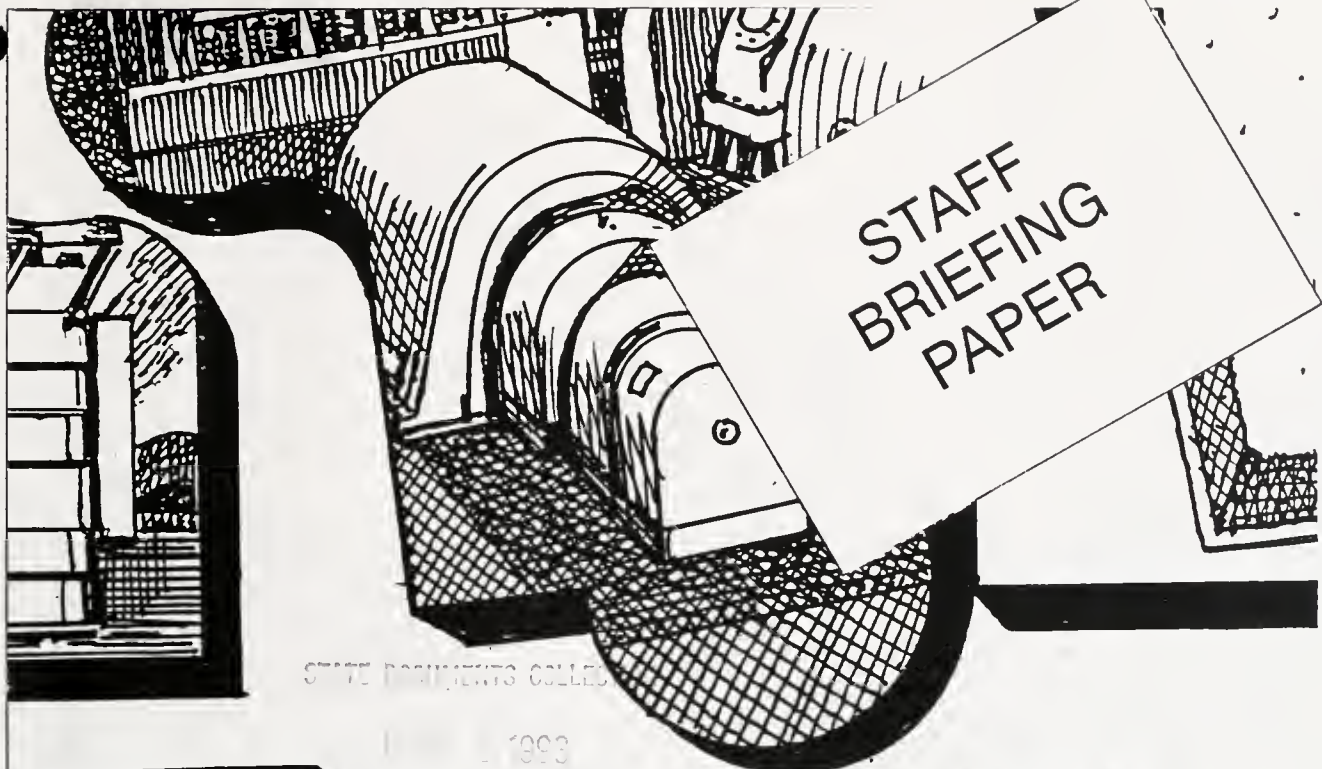


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TRANSFORMING UTILITY ENVIRONMENT

89-31



NORTHWEST POWER PLANNING COUNCIL
September 15, 1989

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September 19, 1989

To Interested Parties:

The Council is circulating the attached staff briefing paper entitled, "The Changing Utility Environment" (publication #89-31).

This activity is part of the Council's process to develop a new Northwest Power Plan in 1990. As the Council examines resources available to the region to meet future demand for electricity, it must also consider any developments that could affect the delivery or pricing of those resources.

A number of changes are going on in the utility arena. These sweeping changes affect utility structure and regulation as well as the acquisition and delivery of resources. The purpose of this briefing paper is to discuss those changes and provoke discussion on how and to what extent, if at all, the changes will affect the Northwest and the regional power plan.

This paper in itself is not expected to lead to conclusions that the Council will take a formal vote on. Rather, by stimulating discussion, the paper is intended to bring to light better knowledge. This will give the Council a more informed background for making subsequent decisions on specific resource issues. It is also possible that all or parts of the discussion in the paper, adjusted to reflect public comment, will be incorporated as background in the new plan.

The Council is actively seeking comment on the issues raised in and related to this paper. **Deadline for comment on this paper is 5 p.m., Friday, October 13. Oral testimony will be taken at the Council's meeting October 11-12 in Spokane, Washington.** It would help us record and circulate your comments quickly and accurately if you would mark your comments with either the issue paper title or publication number.

Sincerely,



Dulcy Mahar, Director
Public Involvement

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Staff Briefing Paper
89-31

The Changing Utility Environment

INTRODUCTION

The utility environment is widely perceived to have changed radically since the oil embargo of 1973. This briefing paper attempts to distinguish between changes in circumstances, which have clearly occurred, but which may change back, and changes in regulation and fundamental structure, which may be ongoing and may not change back without long lags. It also suggests possible trends for the industry, based on extrapolations of current issues, and suggests the role of the Council in relation to those trends.

The issues are wide-ranging and cannot be dealt with in great depth in this briefing paper. Rather, the paper focuses on the effects these industry changes have on the Council's role in the region and on the content and application of its power plan. While the briefing paper draws some preliminary conclusions about the Council's role, these conclusions should be taken as means to focus comment. Public comment is particularly sought on these conclusions, and will help the Council prepare a 1990 Power Plan that reflects significant changes in the environment in which utilities will operate until the plan is next revised.

BACKGROUND: INDUSTRY STRUCTURE -- THE BASIS OF REGULATION

The electric utility industry has had two key characteristics during most of its existence: first, it was vertically integrated and second, it was a "natural" monopoly. The first characteristic means that production, transmission and local distribution services are typically provided by the same corporate entity. The situation in the Northwest -- with one large producer and transmitter, a large number of small distributors, several vertically integrated investor-owned and public generating utilities -- is not common in the rest of the country.

For some perspective on the process of deregulation,¹ this structure may be compared with the natural gas and telecommunications industries before they

1. "Regulation" refers, in this paper, to economic regulation, that is, regulation of prices and market entry. It does not refer to other sorts of government regulation, such as the imposition of environmental, worker safety, or other requirements on businesses.

were deregulated. The gas industry in its early years was vertically integrated, with local distribution companies also manufacturing gas from coal or oil. However, with the widespread availability of natural gas, the industry's vertical integration was eliminated. It was, instead, characterized by a large number of independent producers, and separate transmission pipeline companies and local distribution companies. The telecommunications industry, on the other hand, was more vertically integrated than the electric industry. There the integration extended from manufacture all the way through provision of the means of using the service, since only phones owned and provided by the phone company could be connected to the network. This variation shows that vertical integration, while characteristic of the electric power industry, is not a prerequisite to regulation.

The second characteristic of the electric power industry, natural monopoly, provides the economic basis of regulation.² Natural monopoly means that the service can be provided by one installation at a lower unit cost than by two installations. This is also described as "economies of scale." It is a function of the technology involved and has nothing to do with corporate structure or the importance of the product to modern life. In the electric industry, economies of scale remain in transmission and distribution, and characterized generation into the 1960s. Note that economies of scale are also present in gas transmission (up to a point) and distribution and thus do not explain the differences in degree of the industries' vertical integration. In general these differences are based on historical circumstance or other particular requirements of the technology. An example of the latter in the electric power industry is the technical requirement for electrical stability throughout the system from generation to distribution, a requirement which is easier to meet with with (though does not require) a vertically integrated provider.

Natural monopoly, or economies of scale in technology, would lead multiple competitors to provide service at a higher total cost than could a single firm, but would also lead a single profit-maximizing firm to restrict output and raise prices. Regulation exists to ensure that output is not artificially reduced and that prices are not raised above cost, including a reasonable return on investment. Regulation thus limits market entry and holds prices down.

As noted above, economies of scale are generally held to exist in transmission and distribution, but not in generation. Exhaustion of economies of scale is one basis for the current drive to deregulate generation. The other basis for deregulation is the financially risk-averse attitudes of utilities who often found themselves in the early 1980s with large capital investments in surplus generating plants for which they could not get rate treatment. Utilities in such circumstances support deregulation to enable non-regulated generators to relieve them of the financial risk.

The question of deregulation of transmission, also currently being discussed, is not driven by economic characteristics of the technology. Rather, it is driven by the argument that a deregulated generation sector cannot work unless access

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2. There are a number of other reasons, mostly political, for regulation, which could be seen in industries, such as interstate trucking, for which there was no economic basis for regulation.

to markets, that is, transmission, is available as well. Thus, the changes in the transmission sector are not as likely to involve multiple, competitive entrants as in the generation sector. Instead, they are more likely to involve requirements for access or requirements to build capacity beyond the loads of the constructing utility.

The possible forms deregulation might take, both in the generation and transmission sectors, will be discussed further in later sections of this paper. The next section will briefly review the changes the industry has undergone since the end of the golden age in the 1960s.

CHANGES IN CIRCUMSTANCES AND INDUSTRY STRUCTURE

Two initial questions should be asked: 1) what has changed?, and 2) are the changes permanent or transitory? The first question is easier to answer than the second. While most observers would agree on what things have changed, they disagree on their significance. Furthermore, because of the different roles of the Council and the utilities, even changes that have far-reaching effects on utilities and their management may not have similar effects on the Council and its planning.

Changes in Circumstances

Economic Circumstances: The following section will briefly review the major circumstances that changed since the 1973 oil embargo. The first -- and most influential -- was the dramatic rise in world oil prices between 1973 and 1981. That price jump, magnified by a new awareness of environmental issues, spawned a chain of events including rises in natural gas prices, the dramatic inflation of the 1970s, increasing costs of new conventional generating plants, significant reductions in rates of load growth and the entry of non-utility sellers of electricity into the industry through the Public Utility Regulatory Policies Act of 1978 (PURPA).

These events left the industry in the early 1980s with surpluses of firm energy and capacity, due to lower demands for power because of higher prices and the economic recession of 1981-82 (significantly prolonged in portions of the country, including the Northwest). In addition, state regulators, under pressure to limit rate increases, had limited utilities' ability to recover the funds invested in new and now surplus plants, or in some cases, the full costs of purchased oil or gas. Of the two restrictions, the limits on capital recovery probably had more severe and long-lasting effects on utility motivations.

Since then, several of these effects have reversed. Oil prices declined somewhat into the mid-1980s, then abruptly collapsed in early 1986, recovering to a lower plateau that has held relatively steady since then. Gas prices followed a roughly similar pattern. Expectations for future prices have changed significantly with this change in actual prices. Inflation collapsed in the early 1980s, though it has built back up to late-1960s and early-1970s levels. The reduction in oil and natural gas prices has, however, increased the viability of the independent and industrial generators, who often find that new cogeneration units can compete with existing utility industrial rates, burdened by the inflated

capital cost legacy of the 1970s and even before counting in the benefits available under PURPA.

The situation in the Northwest has followed this general pattern, though with some regional twists. Since Northwest electricity prices started from such a low base, the price increases that came from adding new thermal investment were all the more dramatic, as was the effect on load growth. The recession in the Northwest was prolonged by the high value of the dollar and the high interest rates of the early 1980s, which lagged the decline in inflation. Northwest industrial power rates have never been as high as those in, for instance, California, so the growth of self-generation and cogeneration has not been as significant as it was there, an effect that was strengthened by PURPA prices that were generally lower in the Northwest than in California.

Regulatory Circumstances: The primary change in regulatory circumstances during the late 1970s and early 1980s was that utilities were not necessarily assured of recovering the costs they incurred to serve their customers, if those investments or contracts turned out badly. Regulators conducted reviews of the prudence of those decisions under the "used and useful" statutes that are common to most state regulatory law. These prudence reviews often lead to disallowances of some or all of the funds invested in those projects from rate recovery. This has been described as the "broken regulatory compact." The regulatory compact was generally understood to mean that utility stockholders accepted returns lower than those in other industries, in return for the lower risk involved in virtually automatic pass-through and recovery of costs from rates.

The exclusive franchise to sell is often thought of as part of this compact, though significant competition from other fuels has been an intermittent part of the industry's history, even during the golden age of the 1950s and 1960s. That golden age was characterized by consistent real price decreases, when technological improvements and economies of scale, accessible because of 6 to 7 percent load growth rates, more than offset the effects of the low inflation levels of the time. Even with this inter-fuel competition, however, there was almost no competition to the vertically-integrated utility to generate electricity, for the same technological improvement and economies of scale had left industrial self-generation, a major factor in the electric power industry in the early part of the century, a minor role by this period.

The other change in regulation in this period -- increased market entry allowed by PURPA -- was a problem to utilities to the extent 1) that state regulators forced resources on the utilities at the same time that the utilities were bearing the burden of surplus capacity on which the regulators were not allowing returns and 2) to the extent the prices of those resources were artificially high. As a structural issue in the industry, however, PURPA was not all that significant at the time, though it was the forerunner of current, and more significant, actions to eliminate market barriers.

Changes in Industry Structure

The institutionalization of non-utility sellers of electricity was begun by PURPA. Current activities by the Federal Energy Regulatory Commission

(FERC) and Congress may expand that process significantly. The industry already has begun a set of structural changes in response to the events of the 1970s and early 1980s. Some utilities have transformed into holding companies with non-regulated, and even non-energy related, subsidiaries.

The regulatory process, with returns for stockholders only allowed on investment net of accumulated depreciation, set strict limits on utilities as business ventures. Slow or non-existent load growth, especially when exacerbated by surplus capacity on which no return is allowed by state regulators, offered dismal prospects to utilities. Without load growth, there is little need for significant new investment; meanwhile the existing investment continues to depreciate. The outcome of this process, all else equal, is the slow decline of a utility's rate base and total dollars allowed for returns to stockholders, which can only lead to a continual decline in earnings and dividends. New investments, even unregulated ones, were necessary, and often the only ones available.

CURRENT ISSUES

Holding Company Internal Relationships

The formation of holding companies, with non-regulated, and even non-energy related subsidiaries has become more widespread in the 1980s, probably in response to the situation described above. Most relevant for our concerns is the non-regulated energy subsidiary, though, as the ongoing problems of Arizona Public Service and its parent indicate, the other kind of subsidiary can raise significant issues for regulators. A recent Supreme Court decision³ concluded that state regulators could not reject an allocation of power and cost from a generating subsidiary to a retail operating subsidiary of the same holding company when the allocation had been approved by FERC. The decision aroused a strong reaction from state regulators, who saw it, coupled with FERC's apparent laissez-faire attitude toward wholesale transactions, as a loophole in prudence review at the state level and an invitation to utilities to shape transactions to fit into the most attractive jurisdiction. The Court's opinion viewed it as simply an affirmation of federal authority over interstate commerce and said that in such transactions the burden of prudence review rested solely with FERC.

FERC vs. State Regulators

A good deal of the current uncertainty has to do with the frictions between FERC and state regulators over the line between their authorities and the differences in their approaches to regulation. Historically, FERC has regulated wholesale requirements contracts between utilities (generally a serving investor-owned utility and a served small public utility), on a cost-of-service basis similar to that used by state regulators. Additionally it has regulated on a cost-of-service basis all transmission pricing (except in Texas and Hawaii) and on a

3. Mississippi Power and Light v. Mississippi ex rel. Moore, 108 S.Ct. 2428 (1988)

very loose basis, short-term wholesale transactions between generating utilities. Virtually all other regulation, including retail rates, asset transfers, financing, and certificates of public convenience and necessity for construction, has been the province of state regulation.

The current tension between FERC and state regulators comes from initiatives taken by FERC to deregulate wholesale transactions, to the extent that they have authority. A recent Notice of Proposed Rulemaking on independent power producers proposed that, if certain criteria for lack of market power were met, any negotiated price between a independent power producer and a utility be approved without reference to traditional cost-of-service principles. While appearing reasonable, the issues of holding company relationships and self-dealing were troubling to state regulators, particularly in light of the Mississippi decision mentioned above.

State regulators are continuing on the activist path that began with prudence reviews related to "used and useful" statutes and went on to least-cost planning. On the other hand, FERC is moving toward what it views as deregulation and what others view as simply lax, but still federally preemptive, regulation.

Revision to the Public Utility Holding Company Act

Proposals for changes in the Public Utility Holding Company Act of 1935 (PUHCA) are an additional focus of current interest in deregulation. This act was passed to eliminate the multiple layers of holding companies and unregulated interstate financial transactions between affiliated companies that built up in the early years of the industry and to severely regulate the transactions of holding companies that chose to remain and be registered with the Securities and Exchange Commission. The highly-leveraged holding company structure was extremely attractive to utility owners when consolidation and technological improvements were rapidly dropping the cost of electricity and complex interstate corporate structures could not be adequately regulated by state authorities.

One proposed change would create a category of interstate utility subsidiaries, called exempt wholesale generators, that could exist without subjecting their parents to the regulatory requirements of PUHCA. The requirements are currently thought to be onerous enough that they restrict the formation of such interstate holding companies, and thus inhibit creation of generating subsidiaries that might increase the competitiveness of the generating sector. It should be noted that the Mississippi situation exists in any case, because Middle South Utilities, the parent, is a registered holding company under PUHCA already. Moreover, revision of PUHCA is probably not necessary to allow entry into the generation market by companies which are not now utilities or currently organized as holding companies.

State regulators generally view this proposed change as another assault on state regulatory authority, and the National Association of Regulatory Utility Commissioners (NARUC) has voted to oppose PUHCA changes without assurance that state regulatory authority over the prudence of wholesale purchases by the utilities they regulate will be restored. In addition, the

NARUC resolution calls on Congress to give states the right to form interstate compacts in order to regulate cost allocations and prudence of wholesale purchases by interstate holding companies, entities that are currently regulated solely by FERC.

Transmission Deregulation

Transmission rates are currently regulated, generally on a cost-of-service basis, by FERC, while construction by investor-owned utilities is subject to state regulatory authority. Historically, most transmission has been constructed and sized to connect generators to load centers, rather than to make large bulk power transfers between utilities, or to operate as a common carrier. This situation also is due in part to the nature of the technology. It is generally considered to be subject to economies of scale, which combine with siting difficulties to limit the economic viability of multiple competitors, at least within limited geographic areas.

This means that arguments about transmission are generally about access to a scarce resource, rather than about additional entrants into the market. As might be expected, transmission owners are trying to focus the debate on deregulation of prices, while transmission users, typically non-generating public agencies and independent power producers (including PURPA qualifying facilities) are trying to focus it on mandatory transmission access, usually at average, historical cost. The latter group also includes some large industrial customers who would like the ability to shop for a utility supplier.

One potential scenario for future transmission is suggested by the conditions placed on the Pacific Power and Light merger with Utah Power and Light. In approving the merger, FERC required that Pacific/Utah declare its currently unused transmission capacity, offer it to other utilities, and guarantee to increase its own transmission capacity to serve all the requests of others within five years or be required to reduce its own use of its system for wholesale sales to accommodate other applicants. New capacity built for others could be priced at cost, up to the marginal cost of the addition.

Obligation to Serve

The ultimate level of deregulation would be elimination of the obligation to serve, which would be a radical step. Though it has appeared in limited circumstances, such as the contracts between Pacific Power and Light and some of its large pulp and paper customers,⁴ it is unlikely to become widespread absent some currently-unknown technological changes that would render electricity generally accessible without a distribution system.

However, situations such as that between Pacific and its pulp and paper customers may become more common. It is important, however, to understand

4. The contracts allow Pacific to serve the customer after 1997 at rates that take into consideration full marginal cost, or even potentially refuse service, in return for the customer's not installing cogeneration facilities and instead, taking service from Pacific at a discounted rate.

why this occurred. It occurred because utility rates were forced up by the capital investments of the 1970s and early 1980s, and the abrupt decline in oil and gas prices in the mid 1980s allowed self generation and cogeneration to be an economic alternative to utility service, even at the high discount rates typically used by industry. The problem is largely a function of the current relationship between utility rates and oil and gas prices, not of deregulation.

One other aspect of the obligation to serve worth noting is reliability. The first is whether new non-utility competitors in the generation market will maintain the reliability standards of utilities. While experience in California with qualifying facilities has generally reduced the level of concern about this issue, it may still be an issue.

The second issue, which is more speculative, has to do with the utility reliability standards themselves. One possible outcome of the continuing insistence on post hoc prudence review by state regulators, coupled with the insistence by utilities that they will not build any more capital-intensive projects in the future, could be a stand-off leading to underdevelopment of new resources. Concern that this outcome is likely underlies the deregulation initiatives of FERC, which would create an environment in which state authorities are bypassed. This issue could turn out to be moot, to the extent least-cost planning efforts by state regulators lead them in the direction of implicit, even if not explicit, pre-approval of utility expenditures.

On the other hand, it could turn out to be a continuing issue. Utilities sometimes appear to think that while they are at risk for their own construction expenditures, they will not be for contracts for the output of others' expenditures. If FERC wins the current political struggle with state regulators over the locus of and enthusiasm for prudence reviews, the utility position will be correct. If state regulators win, the utilities could be back in the same position they sought to escape. The situation would be ripe for either degradation of reliability or substitution of fuel for capital as utilities waited until the last minute to make decisions, in order to minimize the risk of those decisions' turning out badly.

What Will the Future Bring?

It seems clear that broadened entry into the wholesale generation market, begun with PURPA, will be expanded. What is not clear is what a mature market for wholesale electric power would look like. Issues such as the degree to which utility holding company relationships will dominate supply discussions, the (possibly) changed position of the line between FERC and state regulatory authorities, and the ability of regulators to conduct prudence reviews of utility acquisitions are interrelated because of current initiatives and attitudes at FERC. Absent those initiatives and attitudes, these issues would probably not be prominent. For instance, the Mississippi case said that FERC is the proper forum for prudence review of wholesale transactions. If FERC were as active in prudence reviews as state regulators, then the authority question would have considerably less substance than it does.

What does appear quite possible is that wholesale transactions will provide a greater portion of new resources for utilities in the future. Moreover, unless

current trends are reversed, those wholesale transactions will not be subject to prudence review, or rejection in any form, by state regulators. The ability of state regulators to enforce least-cost plans may be at some risk (beyond, that is, their continuing ability to lower rates of return, within a reasonable range, to express their dissatisfaction).

IMPLICATIONS FOR THE COUNCIL'S ROLE AND PLAN

The Council was created in an era of centralized utility planning; it was conceived to replace centralized planning done only by Bonneville and the utilities with centralized planning done in a more open and public environment. The Council generally was expected to act within an institutional framework in which Bonneville acquired resources to meet regional loads. Generating subsidiaries were contemplated, but only for acquisition of resources by the Administrator.

It has already become clear that part of this institutional forecast is dated. In the 1986 plan, the Council focused on Bonneville and its current customers separately from the region as a whole, since the investor-owned utilities, and some generating public utilities, have indicated their reluctance to place loads on Bonneville. The 1989 supplement went one step further and separated out the investor-owned utilities as well. The Council's growing consultation involvement in the resource actions of state regulators is further evidence of the importance the Council attaches to different institutional mechanisms than were initially contemplated to be central in the Northwest Power Act.

The developments described in this briefing paper raise further questions about the role of the Council and the plan. At the most extreme, it has been suggested that centralized planning, in the form practiced by the Council, has become irrelevant to utilities struggling to deal with a decentralized, wholesale power market. The final section of this briefing paper will deal with this question. It will address both more general questions about the role of the Council and more specific ones about the content of the plan.

Role: It is not clear that the changes in utility regulation described in this briefing paper will affect the Council. In the narrow view, they will affect it very little. Bonneville acquisition has never been conceived by the Council to depend on utility-provided resources, though this has not been widely appreciated. Although the resource scenarios in the plan have generally used utility financial costs and capital structures, the resource supply curves have used best estimates of resource availability and cost, including the recommendations of non-utility suppliers for some specific kinds of resources, such as cogeneration. The 1983 plan included as one of its policies reliance on "existing market mechanisms and organizations as much as practicable." The 1986 plan included the following discussion in an action item directed to Bonneville resource acquisition:

When the region needs power, it is quite likely that utilities will not be the only developers of resources. Independent developers will likely sponsor many dispersed generating resources, conservation resources and, possibly, central station power plants.

The intent of this activity is to encourage the orderly development of small-scale and high priority resources and to identify and acquire lost opportunity resources as these become cost effective.

Review under section 6(c) of the Northwest Power Act has ultimately to do with the prudence of acquisition decisions, not the supplier of the resource. Thus, it will remain appropriate, and required, whatever the source of the potential Bonneville resource. This review does not mean that the specifics of the resource meet exactly the descriptions in the plan. Rather it means that the Administrator and the Council share a judgment that the resource is consistent with the goals and objectives of the plan. Moreover, the Council-Bonneville relationship is not analogous to state regulator-utility relationships because FERC does not intercede in the former, though it does in the latter.

In the wider view -- that of the Council's planning and plan as models for the actions of regional utilities and their state or local regulators -- the Council's role would still probably remain generally unchanged, though that conclusion is less clear. In one scenario, the conventional vertically-integrated structure is broken up, so that the electric industry comes to look like the gas industry. This industry has many producers, separate transmission and franchised distribution entities, and even some direct access of large retail customers to producers. While least-cost planning does not apply to producers, it is being applied to gas distribution companies, which still have an obligation to serve core customers.

However, to the extent that utility wholesale transactions are subject only to FERC prudence review, as described earlier, the impetus for adhering to least-cost plans may decline, and thus the relevance of such plans by state regulators would decline as well. This assumes the most laissez-faire attitude at FERC, which would generally not do prudence reviews, and at the same time, through federal preemption, prohibit others from doing them.

Some scenarios, such as those in which technology changes enough that the need for distribution systems is eliminated, also eliminate the need for any planning to protect consumers from poor decisions. These scenarios imply that if one local supplier makes bad decisions, the consumer can always go to another supplier. Such scenarios propose to eliminate the obligation to serve. But that seems unlikely as long as conventional distribution technology remains subject to economies of scale and natural monopoly characteristics. Most agree that this is likely to continue for the foreseeable future. This scenario goes much beyond the current situation in which there are conservation and perhaps self-generation opportunities available to all customer classes and utilities have to be concerned with the effects of prices and total bills on demand for their product. The uncertainties these pose for utilities are similar to those that existed in the pre-deregulation environment.

It is conceivable, of course, that the wholesale market for conservation and generating resources could become competitive enough, with sufficient suppliers of both kinds of resources, that market prices would actually be "least-cost." Does this mean that planning is irrelevant? Probably not, because planning only becomes irrelevant when uncertainty does not exist. An arms-length wholesale transaction does not necessarily represent a better decision than the

utility construction of a large thermal plant in the 1970s, if the basis of the decision, for example, need for power, is flawed. A reasonably competitive wholesale power market in itself merely means that utilities are not forced to develop their own resources and that they can trust that the prices they are offered are not inflated. If it is not reasonably competitive, they cannot trust the prices, though they still need not develop their own resources. Neither situation means that there are no decisions to be made.

Plan: Least-cost plans provide the framework within which these evaluations of uncertainty and risk can be made.

The staff and Council have previously argued, in comments to FERC on bidding and conservation, that least-cost plans are essential to proper evaluation of the results of bidding, since they set a standard for what the utility can do against which the bids, both for conservation and generation, can be measured. They have an added, and necessary, function in any bidding for conservation resources because an evaluation of the potential resource is necessary, not just desirable, to prevent cream-skimming and to eliminate overpayments for third party providers. The staff continues to believe that the current level of forecasting and resource evaluation in the plan is appropriate.

Expanded discussion of the role of bidding and other non-utility resource acquisition strategies in the plan is probably appropriate. The Council has reviewed bidding experiences in other states and will continue to be involved in the experiments and initiatives in the Northwest. However, these experiences are not yet indicative of a mature market. It is clear from the experience the region has had with conservation so far that there are substantial market barriers for this resource. To the extent that the independent power sector is a product of avoided-cost pricing under PURPA, it cannot be automatically assumed to be viable in the same form in a more competitive environment.

Finally, as utilities make the transition from the PURPA environment to a market environment, the financial implications of risk allocation will become more apparent. Utilities traditionally had lower costs of capital and were enabled to use more highly leveraged capital structures than competitive industries because they faced relatively lower risk of capital loss. This was described above in relation to the "regulatory compact." Non-utility generators would be expected to have higher costs of capital than utilities, because they face even more risk than utilities. Unless they are more efficient at building resources, or face lower environmental requirements, they should not generally be expected to provide cheaper resources than utilities. Risk allocation is an issue that will be illuminated in the course of development of competitive markets and needs to be followed by the Council.

CONCLUSION

The changes taking place in the utility industry during the past few years will probably continue. Generally they are affecting a number of parties: 1) regulators, by potentially changing their authorities (in some cases reducing them, in others increasing them), 2) private utilities, due to the changes in regulatory authority, 3) publicly owned utilities, largely to the extent that transmission access gets changed, and 4) consumers, via whatever effects the

changes have on utility costs and rates. It is not clear that they would change the role of the Council or especially any particular aspects of its upcoming plan, beyond expanded attention to the results of current experiences with bidding. The Council would like to receive public comment on these preliminary staff conclusions.

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